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IN THE

Supreme Court of the United States

OCTOBER TERM, 1960

No. 288

AMERICAN AUTOMOBILE ASSOCIATION, *Petitioner*,

v.

UNITED STATES

BRIEF FOR PETITIONER

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BRIEF FOR PETITIONER

OPINION BELOW

The Findings of Fact and the Opinion of the Court of Claims are reported in — Ct. Cls. — [R. 51-71]; the opinion of the Court of Claims is reported in 181 F. Supp. 255.

JURISDICTION

The Court of Claims entered its judgment dismissing petitioner's suit on March 2, 1960. Petitioner filed a timely motion for rehearing and for amendment of findings of fact and conclusions of law on March 25, 1960. The Court of Claims entered an order denying

such motion on May 4, 1960. A petition for writ of certiorari was filed by petitioner August 2, 1960 and granted October 10, 1960. Jurisdiction of this Court to review the decision below rests upon 28 U.S.C. Sec. 1255(1).

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations which the case involves are set forth in the Appendix. They are:

Statutes:

Internal Revenue Code of 1939:

Sec. 41, 53 Stat. 24 (1939).
Sec. 42, 53 Stat. 24 (1939).

Internal Revenue Code of 1954:

Sec. 441.
Sec. 446.
Sec. 451.

Treasury Regulations:

Regulations 118:

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Sec. 1.446-1(a) (1957).
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QUESTIONS PRESENTED

(1) Where a motor club establishes by uncontradicted evidence, including expert accounting testimony, that its regularly employed method of accounting for prepaid membership dues is "realistic", is in accord

with generally accepted accounting principles and practices and reflects its income clearly, is that motor club to be denied the use of such method of accounting for federal income tax purposes by reason of the decision of this Court in *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180 (1957)?

(2) Under federal income tax laws, may a motor club which has long employed the accrual method of accounting report annual prepaid membership dues as "income" over the twelve month membership period, instead of entirely in the year of receipt, if its accounting method is in accord with generally accepted accounting principles, results in matching during the same taxable periods the dues received from members with the expenses incurred in serving such members, and clearly reflects the net income of the club?

STATEMENT OF FACTS

This is a federal income tax case. Petitioner, the American Automobile Association, seeks to recover from the United States the sum of $207,994.56 with interest according to law representing deficiencies in federal income taxes and interest improperly collected by the United States for the calendar years 1952 and 1953. [R. 1].

Petitioner is a corporation with principal offices located at 1712 G Street, N. W., Washington, D. C. Petitioner was incorporated in the year 1910 under the laws of the State of Connecticut and was organized and is operated as a nonstock, membership corporation. [R. 1, 7, 58].

Petitioner's activities are divided into two major parts:

(1) Petitioner is a national organization which renders services to affiliated local automobile clubs and their members and which performs services of a public nature in fields relating to motoring and travel. This aspect of petitioner's activities is *not* involved in this proceeding. [R. 1, 7, 58].

(2) Petitioner operates directly as divisions ten local automobile clubs located in various sections of the United States. [R. 1, 2, 7, 58].

Separate books and records are maintained by petitioner with respect to the revenue and expenses of its national operations as contrasted with the revenue and expenses of its ten local automobile clubs. [Supp. R. 22].

Petitioner employs the accrual method of accounting in keeping its books and records and in filing its federal income tax returns. [R. 2, 7, 60].

The taxable year of petitioner is the calendar year. [R. 2, 7].

Substantially all of the funds necessary to carry on the operation of petitioner's divisions are obtained by dues from its members paid for one year in advance. [R. 62].

Petitioner is obligated to provide services for such members over the twelve month period following payment of dues, which services include but are not limited to emergency road service, complete travel information and travel services, bail bond protection, personal automobile accident insurance and similar services. [R. 2, 7, 59].

Although a membership in an automobile club operated as a division of petitioner covers a twelve month period, *a membership is not based on the calendar year.* Instead memberships extend from the month of the year in which the member joins the club to the same month of the following calendar year. [R. 63]. A substantial number of members join each and every month and the number of memberships in effect was constantly increasing during the years in issue. [R. 70].

Under the method of accounting employed by petitioner during the years in issue prepaid dues collected from members of its divisions were not regarded as "income" for accounting purposes entirely in the calendar year of receipt. Instead prepaid dues upon receipt were posted to a liability account labeled "Unearned and Deferred Income." Thereafter, on a time basis as petitioner rendered or made available services to its members, the liability account was debited and petitioner's "income" account was credited so that advance dues were reflected in full as taxable income ratably over the twelve month period that petitioner was obligated to render services to such members—whether or not such period extended beyond the close of petitioner's taxable year. [R. 62, Supp. R. 9, 10]. For example, if a member joined the club on July 1, 1953 and paid annual membership dues of $15.00, petitioner would reflect $7.50 as income in 1953 and the remaining $7.50 as income in 1954.

Prepaid membership costs were accounted for by petitioner in a manner consistent with its treatment of prepaid membership dues. [R. 62].

As of the end of each calendar year prepaid dues collected by petitioner during the year for which no

services could be rendered or costs incurred continued to be reflected on petitioner's books and records in the liability account entitled "Unearned and Deferred Income." Such advance dues were transferred to the "income" account the following year. [R. 61].

Prepaid membership dues collected by petitioner during the years in issue were deposited in petitioner's bank accounts with no express restrictions as to their use for any corporate purposes other than petitioner's contractual obligation to render future services to its members. [R. 63]. As of December 31, 1953 petitioner's liability account for "Unearned and Deferred Income" totaled $1,756,485.46. On such date petitioner's prepaid membership costs equaled $398,482.36. Petitioner had cash on hand in the amount of $1,941,723.88 with which its liabilities could have been satisfied. [R. 13, 14].

As of December 31, 1954 petitioner's liability account labeled "Unearned and Deferred Income" equaled $2,039,264.43. Prepaid expenses equaled $405,706.15. [R. 61]. On such date petitioner had cash on hand in the amount of $1,502,478.97 with which its liabilities could have been satisfied. [R. 13, 14].

The actual costs incurred by petitioner in serving its members during the years in issue were substantially in proportion to membership from year to year with reasonable constancy from month to month. [R. 70-71].

The actual cost incurred by petitioner in serving one member per month during the years in issue was as follows:

Month	1953			1954		
	Average monthly cost per member		Percent of monthly costs to total over prior 5-year period	Average monthly cost per member		Percent of monthly costs to total over prior 5-year period
	Amount	Percent of cost for year		Amount	Percent of cost for year	
January	$1.12	7.71	7.48	$1.12	7.62	7.46
February	1.10	7.57	7.47	1.27	8.62	7.34
March	1.24	8.52	8.54	1.37	9.27	8.44
April	1.32	9.15	8.83	1.24	8.41	8.82
May	1.28	8.84	8.97	1.35	9.18	8.83
June	1.32	9.12	9.03	1.41	9.56	9.07
July	1.35	9.28	8.99	1.34	9.12	8.93
August	1.23	8.52	8.58	1.24	8.41	8.67
September	1.19	8.22	8.15	1.20	8.16	8.26
October	1.19	8.19	8.20	1.17	7.95	8.42
November	1.06	7.29	7.56	1.10	7.49	7.65
December	1.10	7.59	8.29	.91	6.21	8.11
Total	14.50	100.00	100.00	14.72	100.00	100.00

[R. 71].

The method of accounting employed by petitioner with respect to prepaid membership dues was designed to result in matching during the same accounting period the cost of serving its members with the related revenue derived from such members. [R. 68, 69].

The method of accounting employed by petitioner during the years in issue has been used regularly by petitioner since 1931 and was used both before and after petitioner was required to pay federal income taxes. [R. 66].

The method of accounting employed by petitioner during the years in issue is in accord with generally accepted commercial accounting principles and practices, is customarily and generally employed in the motor club field, and in the opinion of qualified experts

in the accounting field, reflects petitioner's net income clearly. [R. 18, 19, 26, 66].

Had the petitioner recognized, assigned and transferred to its gross income account its monthly receipts of dues collected in advance in the proportion to its cost of servicing all of its members each month, instead of ratably over the membership period of twelve months, the proportion of advance dues which would have been recognized and assigned to gross income during the years in issue herein would have been substantially the same as the gross income from dues as determined and reported by the plaintiff under the method of accounting actually employed. [R. 68, 69].

Petitioner's income tax return for the calendar year 1952 reflected net income of $152,975.51. [R. 60]. Petitioner's income tax return for the calendar year 1953 reflected net income of $352,125.84. [R. 60]. The 1954 tax return reported a net operating loss in the amount of $290,184.04. [R. 60].

Upon audit of petitioner's federal income tax returns for the calendar years 1952, 1953 and 1954, the Commissioner of Internal Revenue determined not to recognize for the calendar years 1953 or 1954 the method of accounting employed by petitioner with respect to prepaid membership dues and prepaid membership costs, which is the issue in this proceeding. The Commissioner determined that all prepaid membership dues should be reported as income in the year of receipt. The net effect of such determination was to increase petitioner's 1953 net income to $481,557.59 and reduce petitioner's 1954 net operating loss to $14,412.49. [R. 60].

As a result of the adjustments described above, the Commissioner of Internal Revenue asserted deficiencies in income tax for the calendar year 1952 in the amount of $58,083.58, and for the calendar year 1953 in the amount of $137,907.48. [R. 61, 62]. In May, 1956, these deficiencies in tax plus interest were paid by petitioner. [R. 62]. Petitioner filed timely claims for refund within two years and following rejection of such claims commenced suit July 8, 1958. [R. 1, 62].

SUMMARY OF ARGUMENT

The Internal Revenue Code not only permits, but requires, that "taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books."[1] Both in keeping its books and records and in filing its tax returns, petitioner reported annual prepaid membership dues as "income", over the period of time that services were rendered or made available, rather than entirely in the taxable year of receipt—in accordance with generally accepted principles of accrual accounting. Use of the accrual method of accounting is expressly authorized by Section 446(c)(2) of the Internal Revenue Code of 1954, and has been approved by every Revenue Act since 1916, provided only that income is clearly reflected. The purpose of accrual accounting is to permit the matching of income with related costs in the same taxable periods.[2] Section 451 of the 1954 Internal Revenue Code, and a corresponding provision of all Revenue Acts since 1918 recognizes that an item of income may be properly

[1] Int. Rev. Code of 1954, Sec. 446(a).

[2] *United States* v. *Anderson*, 269 U.S. 422, 440.

accounted for in a taxable year *different* from the year of receipt. The decisions of this Court recognize that under accrual accounting it is not *the actual receipt* of money that determines the time of its inclusion in income.[3]

The Regulations of the Treasury Department expressly provide that "a method of accounting which reflects the consistent application of generally accepted accounting principles . . . will ordinarily be regarded as clearly reflecting income. . . . ."[4] The court below found as facts, *inter alia*, that petitioner's method of accounting was used regularly since 1931, was in accord with "generally accepted commercial accounting principles",[5] resulted in a precise matching of expense and related revenue, since the computation of petitioner's income would have been "substantially the same" if advance dues were reported as income when related costs were actually incurred,[6] and was more "practicable" than assigning advance dues to income as costs were actually incurred.[7]

The Commissioner of Internal Revenue is not empowered to force petitioner to change its long standing method of accrual accounting, unless its method of accounting fails to reflect income clearly.

Petitioner's method of accounting does reflect its income clearly because it is in accord with generally

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[3] *Spring City Foundry Co.* v. *Commissioner*, 292 U.S. 182 (1934); *Hansen* v. *Commissioner*, 360 U.S. 463 (1959).

[4] Treas. Reg., sec. 1.446-1(a)(2) (1957).

[5] Finding 22, R. 66.

[6] Finding 26, R. 69.

[7] Finding 28, R. 69.

accepted accounting principles and results in matching in the same taxable periods advance dues received from members with the related costs of serving such members which is the essential purpose of accrual accounting.

ARGUMENT

1. The starting point in determining whether a method of accounting is acceptable for federal income tax purposes is whether the method of accounting reflects income clearly.

The solution to the problem of whether a pro rata part of advance dues may be reported as taxable income later than the year of receipt depends upon a construction of Sections 41 and 42 of the Internal Revenue Code of 1939 and Sections 446 and 451 of the Internal Revenue Code of 1954. Section 446(a) of the 1954 Code and corresponding sections of prior revenue acts require that:

> "Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books."

Section 451 of the 1954 Code and corresponding provisions of prior revenue acts provide that:

> "The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, *unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.*" (Italics supplied.)

Since the Commissioner of Internal Revenue contends that petitioner's method of deferral of advance dues is not one of the methods of accounting permitted under Section 446, the first point to be considered is

the standard by which a method of accounting which is acceptable for tax purposes may be identified. Clearly Section 446(c) of the Internal Revenue Code of 1954 and corresponding provisions of prior revenue acts expressly authorize the use of "an accrual method" of accounting.

Section 446(b) of the 1954 Code further provides that:

> "If no method of accounting has been regularly used by the taxpayer, or *if the method used does not clearly reflect income*, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income." (Italics supplied.)

The quoted provision contains the only enumerated basis upon which the Commissioner of Internal Revenue may disallow a method of accounting. The problem therefore must be to identify the standard which must be applied to determine whether petitioner's accrual method of accounting does or does not clearly reflect its income.

The accrual method of accounting was not permitted for federal income tax purposes until the Revenue Act of 1916[8] and was authorized "apparently in response to mounting pressure from economists and businessmen to create some coherence in the relation between accounting for income and for income taxation. . . ."[9]

Section 13(d) of the 1916 Revenue Act provided as follows:

> "A corporation . . . keeping accounts upon any basis other than that of actual receipts and dis-

[8] 39 Stat. 756-77 (1916).

[9] May, "Accounting and the Accountant in the Administration of Income Taxation," 47 Colum. L. Rev. 377, 380-381 (1947).

bursements, unless such other basis does not clearly reflect its income, may, subject to regulations made by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, make its return upon the basis upon which its accounts are kept, in which case the tax shall be computed upon its income as so returned."[10]

In describing the purpose of the above-quoted amendment, the Report of the Committee on Ways and Means of the House of Representatives explained:

> "As two systems of bookkeeping are in use in the United States, one based on the cash or receipts basis and the other on the accrual basis, it was deemed advisable to provide in the proposed measure that an individual or a corporation may make a return on either the cash or accrual basis if the method selected clearly reflects the income."[11]

It will be noted that original Congressional approval of accrual accounting bestowed upon the Commissioner of Internal Revenue wide discretion with respect to its use. Only if the corporation kept its books on the accrual basis, if the cash basis did not reflect income clearly, and if the method of accrual accounting complied with the Commissioner's regulations was its use acceptable for income tax purposes.

With the enactment of the Revenue Act of 1918, however, the situation was reversed and a taxpayer who employed the accrual method of accounting in keeping its books and records was not only permitted, but required, to file its federal income tax returns on the same basis. The authority of the Commissioner of

[10] 39 Stat. 771 (1916).

[11] H. R. Rep. No. 922, 64th Cong., 1st Sess. 4 (1916).

Internal Revenue to disapprove the use of a method of accounting was limited to those cases where the method employed failed to reflect income clearly. The language of Section 212(b) of the 1918 Act, which has remained unchanged in substance until the present time, was as follows:

> "The net income shall be computed upon the basis of the taxpayer's annual accounting period . . . in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income."[12]

Section 213(a) of the Revenue Act of 1918 was the original source of the provision that:

> "The amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer, *unless . . . any such amounts are to be properly accounted for as of a different period*; . . ."[13] (Italics supplied.)

In a decision of the United States Board of Tax Appeals rendered February 28, 1925, these legislative developments were reviewed as follows:

> "We thus see the steady development, through the Acts passed by Congress from 1909 to 1918, of the concept of measuring income either upon a cash receipts and disbursements basis or upon the accrual basis. We see how slowly Congress moved

[12] 40 Stat. 1064, 1065 (1918).

[13] 40 Stat. 1065 (1918).

away from the cash receipts and disbursements basis unequivocally laid down in the Act of 1909 through the grudging admission of the alternative accrual basis in 1916 and 1917 to the absolute requirement of the alternative basis as set forth in the Act of 1918."[14]

This Court first surveyed the legislative development through 1916 in *United States* v. *Anderson*, and concluded that the accrual method of accounting was authorized

> "to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income *earned* during the taxable period, the expenses incurred in and properly attributable to the process of *earning* income during that period . . . ."[15] (Italics supplied).

This principle was applied to require a taxpayer, which employed the accrual method of accounting, to accrue in 1916 in advance of payment, munitions taxes imposed for the year 1916 but not payable until 1917.

The Regulations of the Treasury Department explain the standards by which a method of accounting which is acceptable for federal income tax purposes may be identified, as follows:

> "A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income. . . ."[16]

[14] *Henry Reubel*, 1 B.T.A. 676, 678 (1925).

[15] 269 U.S. 422, 440 (1926).

[16] Treas. Reg., sec. 1.446-1(a)(2) (1957).

Similarly, under the 1939 Code provisions, the applicable regulations were:

> "Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income."[17]

The starting point therefore is the standard of "scientific accounting principles" to determine whether the deferral method here employed by the petitioner did or did not "reflect its income clearly."

2. Petitioner's method of deferral of prepaid dues was in accord with generally accepted accounting principles.

There are three basic principles of accrual accounting which require the method of deferral employed by petitioner in this case.

The first accounting principle involves the distinction between a "financing" transaction and an "income or revenue" transaction.

The American Automobile Association was incorporated without capital stock of any kind. As a nonstock, membership corporation it is different from most other business organizations. A different approach to financing its activities is therefore required. Most business corporations obtain financing through the issuance of stock or by loans obtained from banks, insurance companies or other lenders. Since petitioner has no capital stock, this source of financing is unavailable to it. In its divisions petitioner obtains funds with which to operate by means of a third type of financing transaction—i.e., advances from members. Th vances are in the form of prepaid membership d

[17] Treas. Reg. 118, sec. 39.41-2(a) (1953).

Under generally accepted accounting principles money obtained in a financing transaction whether by issuance of stock or by loan from institutional or other lenders or by advances from members or customers is regarded as a liability upon receipt.

It is for this reason that dues collected in advance of the rendition of services are posted to a liability account.

The second basic principle of accrual accounting is that "income", or revenue as the accountants describe it, emerges only as goods are delivered or services are rendered. In other words, what goes on line (1) of an income statement in the case of a service organization such as petitioner is the value of services which are rendered or made available. Under accrual accounting, it is performance which results in realization of income. Typical quotations from recognized accounting textbooks discussing the above accounting principles are as follows:

> ". . . all customer advances are clear-cut liabilities. When he deposits funds before receiving goods or services, the customer is in effect extending credit to the vendor. . . . Revenue arises as the product is delivered; receipt of cash in itself does not establish the existence of revenue. These basic facts should not be overlooked in setting up the pattern of accounting for such transactions.
>
> ". . . Advances represent neither earned nor realized revenue and to levy income taxes on such amounts violates accounting principles and basic legal rules, including the underlying structure of tax law itself. It would be scarcely more unreasonable to hold that money borrowed from a bank is income than to insist that money advanced by a customer must be so treated."[18]

[18] Paton & Dixon, Essentials of Accounting, 211-212 (1958).

Similarly, in the "Accountants' Handbook" which for many years has been considered the standard reference work on accounting principles, the paragraph entitled "Deferred Revenues" states:

> "Deferred revenues appear when collection is made in whole or in part prior to the actual furnishing of service or transfer of title to goods. An outstanding example is found in the insurance field where premiums are regularly collected in advance for a considerable period. 'Advances by customers' is usually a better description for statement purposes than 'deferred revenues.' "[19]

Under the heading "Advances by Customers" Harold Bierman, Jr., writes:

> "When a customer makes a payment in advance of the service to be performed, this creates a liability on the part of the company receiving the payment."[20]

Finney and Miller, authors of a textbook series used by hundreds of colleges and universities, state:

> "The portion of revenue collected in advance that has not been earned at the end of the accounting period remains in an unearned revenue account, where it represents an obligation to be satisfied, not by the payment of money, but by the rendering of service."[21]

Roy B. Kester, author of "Principles of Accounting," Ronald Press Co., New York, 1939, states at page 518 that the "unearned income" account:

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[19] Wixon & Kell, Accountants' Handbook, sec. 20, 3-4 (1956).

[20] Bierman, Managerial Accounting, 112 (1959).

[21] Finney & Miller, Principles of Accounting—Introductory (1957).

> "... reflects the liability of the business to render to the customers, i.e., the payers or contributors of the income, the service or commodity paid for by them in advance. The account is a true liability account and will be carried in the ledger in the liability section. At the end of each month, or other fiscal period, the portion of this income estimated as equitably belonging to the current period will be transferred from the unearned income account to an appropriate income account ..."

As these principles of accounting are applied to a motor club, it becomes apparent that when a member pays dues in advance for services to be rendered during a future period of time, the advance dues upon collection must be reflected in a liability account—not an income account. Thereafter, a pro rata part of the advance dues must be removed from the liability account and reflected in an "income" account of the motor club as the obligation of the club to the member is satisfied by performance or as the obligation expires. At the end of the annual accounting period, that portion of advance dues for which services have not yet been rendered and for which costs have not yet been incurred remains in the liability account until the following year when performance takes place, or the obligation expires.

The third cardinal principle of accrual accounting, which is consistent with the two preceding principles, and which has been expressly approved by this Court,[22] is as follows:

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[22] *United States* v. *Anderson*, 269 U.S. 422 (1926); *Lewyt Corp.* v. *Commissioner*, 349 U.S. 237, 242-243 (1955).

> "The recognized purpose of accrual accounting is to determine income properly by matching appropriate costs against related revenues."[23]

Only if the costs incurred by petitioner in serving its members are matched in the same taxable periods with related prepaid dues received from its members can it be determined whether petitioner earns any income at all.

While this Court, obviously, is not bound to consider all of the niceties of accrual accounting in interpreting federal income tax statutes, the cardinal principles of accounting should not be ignored where the applicable statutes and regulations are phrased in accounting terms, and where the issue involved is whether income is clearly reflected.

Petitioner directs the attention of this Court to these three basic principles of accrual accounting in confirmation of the finding of fact made by the court below that its method of accounting does conform with standard commercial accounting principles, and in support of the conclusion of the Commissioner of the Court of Claims that petitioner's method of accounting for prepaid dues reflects its income clearly.

The court below also found as a fact that the costs incurred by petitioner in serving its members were in proportion to membership from year to year with reasonable constancy from month to month. The average cost incurred by petitioner in serving one member per month was relatively constant.

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[23] Freeman, "Tax Accrual Accounting for Contested Items," 56 Mich. L. Rev. 727, 728 (1958). See also Shannon, Legal Accounting 162 (1951); Paton, Accountant's Handbook, 113 (1950); Finney & Oldberg, Lawyer's Guide to Accounting, 78 (1955).

Since petitioner files its income tax returns on a calendar year basis, but its members join and prepay dues for a twelve month period which does not coincide with petitioner's calendar year, it is obvious that appropriate costs cannot be matched with related revenues unless advance dues are recognized as income over the membership period rather than entirely in the year of receipt. For example, if a member joins on July 1 of a calendar year and prepays annual dues of $15.00, and if the costs incurred by petitioner in serving its members average $1.20 per member per month, or $14.40 per member for a twelve month period, true income will not be clearly reflected unless $7.50 of advance dues is reported as income in the calendar year the member joined, and the remaining $7.50 in the following calendar year. Under accrual accounting, petitioner earns a profit of 60 cents from this membership, half of which is reported as income in the year the member joined and the remaining half in the following calendar year. By contrast, under the method of accounting which the respondent seeks to impose upon petitioner, petitioner would report $15.00 as taxable income in the calendar year the member joined; actual costs incurred in such year in serving such member would equal only $7.20 ($6 \times 1.20 = \$7.20$); therefore a fictitious profit of $7.80 would be subjected to federal income taxes.

Obviously under the respondent's method of accounting there is no matching of appropriate costs with related prepaid dues, which is the cornerstone of accrual accounting.

Since this is not a case where petitioner seeks to change its method of accounting, but a case where

petitioner has regularly employed the same method of accrual accounting for many, many years, petitioner contends that in order to prevail, it need prove only that the respondent was incorrect in asserting that petitioner's method of accounting fails to reflect income clearly. This petitioner has done.

3. The principles of accrual accounting as enunciated by this Court support petitioner's position

The principles governing the reporting of income by taxpayers who employ the accrual method of accounting have often been considered by this Court. In *Brown* v. *Helvering*,[24] this Court pointed out:

> "If the accounts are kept on the accrual basis the income is to be accounted for in the year in which it is realized even if not then actually received; and the deductions are to be taken in the year in which the deductible items are incurred."[25]

In *Spring City Foundry Co.* v. *Commissioner*,[26] this Court differentiated between reporting income on the cash receipts and the accrual methods of accounting as follows:

> "Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the right to receive *and not the actual receipt* (italics supplied) that determines the inclusion of the amount in gross income. When the *right* to receive an amount becomes fixed, the right accrues. When a merchandising concern

[24] 291 U.S. 193 (1934).

[25] 291 U.S. at 199.

[26] 292 U.S. 182 (1934).

> makes sales, its inventory is reduced and a claim for the purchase price arises.'"[27]

This principle was reiterated by this Court in *Security Flour Mills Co.* v. *Commissioner*,[28] and again emphasized in the recent decision of *Hansen* v. *Commissioner*.[29]

In all of these cases the taxpayer was required to report taxable income before the actual receipt of cash.

(a) Under accrual accounting the time when cash is received does not govern the time of its inclusion in income

This Court has made it unmistakably clear that in accrual accounting the time when cash is actually received does not control the time of its inclusion in gross income for tax purposes. Since this is a correct principle of accrual accounting where cash is received after the year the profit is realized, it is equally sound where cash is received before the year in which the profit is realized.

Accrual accounting would be a trap for the taxpayer and an unfair one way street for the Government if the respondent prevails in this case, for the respondent contends that despite the principles of accrual accounting as laid down by this Court, it is the actual receipt of cash that is controlling for tax purposes in this case.

Stated another way, the respondent's contention is that an accrual basis taxpayer must report cash as taxable income either on the cash receipts basis or on

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[27] 292 U.S. at 184, 185.

[28] 321 U.S. 281 (1944).

[29] 360 U.S. 463 (1959).

the accrual basis, whichever gives the respondent the earliest opportunity to collect the income tax and irrespective of whether the taxpayer's income is reflected clearly. Certainly this one way street is not in accord with principles of sound accrual accounting, and not in accord with the decisions of this Court.

Further analysis of these cases permits identification of the events which must occur in order for an accrual basis taxpayer to earn income. In *Brown* v. *Helvering, supra,* it was explained that under accrual accounting:

> "... income is to be accounted for in the year in which it is *realized*. ..."[30] (Italics supplied.)

In *Spring City Foundry Co.* v. *Commissioner, supra,* this Court, in describing the events which required accrual of income, stated:

> "When a merchandising concern makes sales, its inventory is reduced and a claim for the purchase price arises."[31]

which event fixed the right of the taxpayer to income.

In other words, in the case of an accrual basis merchandising concern not only sales but delivery, i.e., reduction of inventory, must have occurred for the taxpayer to have realized income. By analogy, in the case of an accrual basis service organization such as the American Automobile Association, the furnishing or making available of services must occur for taxable income to be realized.

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[30] 291 U.S. at 199.

[31] 292 U.S. at 185.

(b) Under accrual accounting, an item of expense may be deducted in a year different from the year of payment

From the deduction point of view as well as from the income point of view, the purpose of accrual accounting is to reflect true economic income. In discussing true income under accrual accounting, this Court, in *United States* v. *Anderson, supra,* laid down a principle with respect to the accrual of liabilities which is often referred to as the "all events" test. The taxable year in which a munitions tax accrued was determined as follows:

> "In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due; but it is also true that in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it. In this respect, for purposes of accounting and of ascertaining true income for a given accounting period, the munitions tax here in question did not stand on any different footing than other accrued expenses appearing an appellee's books. In the economic and bookkeeping sense with which the statute . . . [was] concerned, the taxes had accrued."[32]

Petitioner argues that a necessary corollary to the "all events" test established in the *Anderson* case should be applied where prepaid receipts are involved. The corollary would be that until substantially all events have occurred in connection with prepaid receipts, which would include incurring the costs essential to satisfy the obligation for which the prepaid money was received, the true income of a taxpayer is distorted unless prepaid receipts are reported as income in a

[32] 269 U.S. at 441.

manner which results in matching the cost of performance with related revenue.

In *Security Flour Mills Co.* v. *Commissioner*, *supra*, this Court made it clear that under accrual accounting the deduction of an item of expense could *follow* payment as well as *precede* payment under proper circumstances.

In that case, this Court referred to Section 43 of the 1939 Code[33] which provided that:

> "The deductions and credits . . . provided for in this chapter shall be taken for the taxable year in which 'paid or accrued' or 'paid or incurred', dependent upon the method of accounting upon the basis of which the net income is computed, *unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. . . .*" (Italics supplied.)

The origin of the above-quoted provision was traced by this Court to Section 200(d) of the Revenue Act of 1924, the legislative history of which was quoted as follows:

> "The necessity for such a provision arises in cases in which a taxpayer pays in one year interest or rental payments or other items for a period of years. If he is forced to deduct the amount in the year in which paid, it may result in a distortion of his income which will cause him to pay either more or less taxes than he properly should."[34]

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[33] 53 Stat. 24 (1939). The 1954 Code counterpart is Section 461.

[34] H. Rep. No. 179, 68th Cong., 1st Sess. 10, 11 (1924); S. Rep. No. 398, 68th Cong., 1st Sess. 10, 11 (1924).

Surely, if under accrual accounting the accrual of an item of expense can follow payment, as is clearly true in the case of prepaid expenses, the accrual of income must likewise follow receipt where prepaid receipts are involved.

Where money is received by a taxpayer in advance of the rendition of services for which substantial costs must be incurred, such money is either totally or partially unearned and should not represent taxable income. Clearly the concept of prepaid receipts requires consideraation of factors which are not present in dealing with concededly earned income. The issue involved in this case therefore represents a different type of problem from any which has been considered on the merits by this Court.

(c) The claim of right doctrine as enunciated by this Court is not applicable to this case

The "claim of right" doctrine as enunciated by this Court deals with the year in which an item of *earned income* must be reported for tax purposes even though there is a possibility the taxpayer cannot keep the income. These cases individually, or collectively as they establish the so-called "claim of right" doctrine, do not stand for the proposition that prepaid receipts must be reflected as taxable income before the product is delivered, before the services have been rendered, or before the costs have been incurred.

The claim of right doctrine appears to have been first applied in a tax case by this Court in *North American Oil Consolidated* v. *Burnet*.[35] In that case the taxpayer and the government disputed the owner-

[35] 286 U.S. 417 (1932).

ship of certain oil properties. A receiver was appointed pending a determination. In the year 1916, under the control of the receiver, the oil wells were operated at a net profit. In 1917 the court battle was resolved in the taxpayer's favor at the trial level and consequently the receiver paid over the sums representing 1916 profits to the taxpayer. The taxpayer sought to treat this profit, which was conceded to be net profit, as taxable income in the year 1916.. The Commissioner asserted that the profits were taxable in 1917 when North American Oil first had possession. Taxpayer countered with the argument that if the profits were not taxable to it in 1916, they should not be taxable until 1922 when its right to retain the profits became final on disposition of an appeal by the Government to the appellate courts. This Court held that the net profits earned in 1916 were not taxable to petitioner in 1916 since it "was not required to report as income an amount which it might never receive." As between the remaining years 1917 and 1922 this Court held the income taxable in 1917, explaining its reasons as follows:

> "If a taxpayer receives *earnings* under a claim of right and without restriction as to its disposition, he has received income which he is required to return even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent."[36] (Italics supplied.)

It is clear that the facts in *North American Oil Consolidated* v. *Burnet*, *supra*, are not applicable by analogy to this case, for here the advance dues received by petitioner were not earned since petitioner was re-

[36] 286 U.S. at 424.

quired to make substantial expenditures in order to render services in the year following receipt of such dues.

In *Brown* v. *Helvering, supra,* the taxpayer was a general agent for insurance companies and received commissions on policies, the terms of some of which extended beyond one year. If a policy was canceled, Brown was required to refund a proportionate part of the commission to the insurance company. Under Brown's method of accounting, he treated all commissions as income in the year received, and if a policy were canceled, he deducted the refund as an expense in the year paid. He sought to change his method of accounting in order to charge to expense in the year in which a commission was received an estimated reserve representing refunds that might have to be made in the future. This Court held that Brown was not entitled to take a current deduction for contingent refunds he might have to make in future years.

But Brown made an alternate contention—that the cash commissions received should have been included as gross income on a deferred basis pro rata over the life of the policy. As to his alternate contention, this Court held against Brown for two significant reasons:

First, the Court pointed out that Brown had never kept his books of account on that basis as required by statute.

Second, this Court explained:

> "Moreover, the Board concluded that there 'is no proof that the overriding commissions contain any element of compensation for services to be rendered in future years.'"[37]

[37] 291 U.S. at 204.

In *United States* v. *Lewis*,[38] the taxpayer in 1944 received a bonus as compensation for services rendered as an employee. Subsequently, due to error detected after the close of the year, Lewis was required to return a part of the bonus following litigation over the matter. This Court required the taxpayer to report the bonus as taxable income when received. A deduction would be allowable in the subsequent year of repayment.

In cases of this type no services remain to be rendered and no expenses remain to be incurred.[39]

4. The position of the Respondent is contrary to the regulations of the Treasury Department, and to recent decisions of the United States Courts of Appeal

The Commissioner's own regulations promulgated pursuant to the provisions of Sections 446 and 451 of the Internal Revenue Code of 1954 provide as follows:

> "It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. *A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross in-*

[38] 340 U.S. 590 (1951).

[39] Cf. *Rutkin* v. *United States*, 343 U.S. 130 (1952); *Healy* v. *Commissioner*, 345 U.S. 278 (1953).

come and expense are treated consistently from year to year." [40] (Italics supplied.)

Similarly, under the 1939 Code the Regulations contain the following statement:

"*Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income.* A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. . . . All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. . . ." [41] (Italics supplied.)

The early position of the Commissioner of Internal Revenue was in accord with petitioner's interpretation of the law.

In I.T. 2080,[42] the taxpayer was a travel agent engaged in the business of running various cruises and tours. In the last two months of the year the taxpayer received substantial deposits for tickets in connection with cruises which were to take place the following year. The Bureau ruled that the taxpayer was required to employ the accrual method of accounting in order to reflect its income clearly and was required to defer the inclusion in income of advance payments received from customers until the year in which the

[40] Treas. Reg., sec. 1.446-1(a)(2) (1957).

[41] Treas. Reg. 118, sec. 39.41-2(a) (1953).

[42] III-2 Cum. Bull. 48 (1924).

expenses involved in operating the cruise would take place.

In I.T. 3369 the Commissioner noted that two methods of accounting were followed by publishers of periodicals. Under the first method the publisher reported income from prepaid subscriptions in the year of receipt. Under the second method prepaid subscription income was deferred as taxable income until the year the newspaper, magazine or other periodical was published and delivered. The Commissioner ruled:

> "It is held that where a publisher of periodicals has, over a period of years, followed consistently either of the two methods outlined above, he may continue to file his returns on such basis, he will not be required to change to the other basis, and his net income for the past years will not be redetermined on such other basis."[43]

For many, many years the Commissioner with no statutory authority except Sections 446 and 451 of the 1954 Code and corresponding provisions of prior revenue acts, has approved two methods of accounting for income derived from "long term contracts" which are consistent with sound accrual accounting practices and which support petitioner's position in principle. Long term contracts, however, are defined by the Commissioner to mean only "building, installation, or construction contracts covering a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and

[43] 1940-1 Cum. Bull. 46, 47.

accepted.'"[44] Where long term contracts are involved a taxpayer can employ either the "percentage of completion" method of accounting or the "completed contract method." Under either method advances or prepayments are reported as income later than the year received by the taxpayer. For example, if a builder contracts to construct a $100,000 building and receives a $40,000 down payment, the $40,000 down payment is not reported as taxable income until the costs of completing the building are incurred, or at least until a pro rata part of the costs are incurred—provided the contract extends for a period of more than twelve months.

The Commissioner's "long term contract regulations" do not expressly apply to a building contract involving a period of less than twelve months. If the contract previously described was entered into in December, and the builder was a calendar year taxpayer, and if the building involved were completed in less than twelve months, the $40,000 down payment would presumably constitute taxable income in the year of receipt unless the statutes, regulations and accounting principles upon which petitioner relies are applicable. A ridiculous result is produced if the builder, upon completion of the building, actually earns a profit of $1,000 or incurs a loss. There is no decided case where the Commissioner has taken this extreme position in the case of a builder, yet such a position would be totally consistent with the Commissioner's position in the case at bar.

In recent years the Commissioner of Internal Revenue has been adamant in holding that regardless of

[44] Treas. Reg., sec. 1.451-3 (1957).

the taxpayer's method of accounting "prepaid income" cannot be deferred beyond the taxable year of receipt because of a long line of judicial authority which allegedly holds

> "that where a taxpayer receives prepaid income under a claim of right and without restriction as to its disposition, it must report the entire amount received each year as income."[45]

However, the United States Courts of Appeal has disagreed with the Commissioner of Internal Revenue more often than not where the taxpayer could prove its method of accounting reflected income clearly.

The current status of lower court decisions on this issue is as follows. The Tax Court, the Court of Appeals for the Sixth Circuit (in *Automobile Club of Michigan* v. *Commissioner*[46]), and the Seventh Circuit (in *Streight Radio & Television, Inc.* v. *Commissioner*[47]) have rendered decisions applying the claim of right doctrine to concededly unearned receipts although absence of proof that the method of accounting clearly reflected income appeared to be the controlling factor in some instances.

The Courts of Appeal for the Second, Eighth and Ninth Circuits have rendered recent decisions fully supporting the deferral of prepaid receipts where the taxpayer has consistently employed the accrual method of accounting and proved that deferral was essential in order to reflect income clearly.

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[45] Rev. Rul. 60-85, 60-10 I.R.B. 14.

[46] 230 F. 2d 585 (6th Cir. 1956), aff'd 353 U.S. 180 (1957).

[47] 280 F. 2d 883 (7th Cir. 1960), (petition for writ of certiorari filed).

The initial decision of a Court of Appeals squarely supporting petitioner's position was *Beacon Publishing Co.* v. *Commissioner.*[48] In that case a publisher not entitled to the benefits of I.T. 3369, *supra,* who received subscriptions payable in advance for a period of several years was permitted to defer the inclusion in income of advance subscriptions until the year when the magazine would be delivered and the cost of publishing the magazine would be incurred. The Court explained its position in the following language:

> "Plainly, Section 42 contemplates that prepaid sums can be returned in a year other than when received. It says that income shall be included in the taxable year received, 'unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period.' This is not a case where the Commissioner has exercised his broad discretion to require a taxpayer to adopt an accounting method which will clearly reflect income, but is one in which he has improperly applied a legal principle."[49]

The leading decision in support of petitioner's position is *Bressner Radio, Inc.* v. *Commissioner.*[50] The *Bressner Radio* case was decided two years subsequent to the decision of this Court in *Automobile Club of Michigan.*

In *Bressner Radio* the taxpayer was in the business of selling television sets and electrical appliances. Its books were kept on the accrual basis of accounting:

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[48] 218 F. 2d 697 (6th Cir. 1955).

[49] 218 F. 2d at 701.

[50] 267 F. 2d 520 (2d Cir. 1959), rev'g 28 T.C. 378 (1957).

its income tax returns were filed on the same basis. As an inducement for a customer to buy a television set in the early days when sets were untried and repairs were numerous, the taxpayer entered into a "service contract" for television receivers under which the taxpayer agreed

> "to service the television receiver . . . and to furnish to the purchaser all labor, replacement of parts and tools . . . necessary to provide proper operation . . . for a period of [twelve months] from the date of this contract." [51]

Contracts were entered into throughout the taxable year. The average price received by taxpayer per contract varied between $80 and $100. Payments were made by most purchasers in installments. Taxpayer discounted most contracts with a bank for cash. Taxpayer's initial cost of installing the television set covered by the contract was approximately 1/4th of its total estimated costs per contract. Taxpayer's experience showed that eight to twelve service calls per set, on the average, were made during the twelve month period during which each contract was in force. Taxpayer reflected as income 25% of the service contract price at the time of installation and spread the balance over the twelve month period of the contract. Services rendered by taxpayer, other than installation, were only at the request of the owner of the set. Taxpayer introduced substantial proof that its method of accounting clearly reflected its income. The Tax Court ignored the evidence and held for the Commissioner, relying upon the claim of right doctrine. The Court of Appeals for the Second Circuit reversed.

[51] 267 F. 2d at 521

holding that the taxpayer's method of accounting clearly reflected its income.

After carefully analyzing the decisions of this Court on accrual accounting, the Second Circuit concluded that the use of "scientific accounting principles" was the cornerstone of tax accounting and tax law, that the claim of right doctrine was not applicable to an accounting problem of this type, and that the decision of this Court in *Automobile Club of Michigan, supra*, was distinguishable for several reasons, including failure of proof by the taxpayer.

The Court then went on to conclude that the taxpayer before it had not used an artificial method of deferral, stating:

> "Drawing on its experience with thousands of contracts it has demonstrated that it was subjected to a reasonably uniform demand for services, so that it could and did anticipate that the expenses incident to the performance which alone would entitle it to regard the sum received as earned would be distributed across the life of the contract. It therefore deferred revenues until they were earned, and thus matched them with foreseeably related expenses, which is the essential purpose of accrual accounting. *United States* v. *Anderson*, 1926, 269 U.S. 422, 46 S. Ct. 131, 70 L. Ed. 347."[52]

The Solicitor General did not apply for a writ of certiorari in the Bressner Radio case.

The most recent case supporting the position of taxpayer is *Schlude* v. *Commissioner*.[53] Taxpayers in that case were husband and wife who formed a part-

[52] 267 F. 2d at 528.

[53] 283 F. 2d 234 (8th Cir. 1960) (petition for cert. filed).

nership to operate Arthur Murray Dance Studios in the midwest. Several types of contracts were entered into between the partnership and students desiring lessons, but in almost all instances the student was required to prepay the cost of future lessons either in the form of cash or by note (lessons for which taxpayers were obligated extended beyond the end of the taxable year). Employing the accrual method of accounting, taxpayers regarded advance payments as a liability upon receipt and included advance payments as "income" as lessons were given or as the obligation to give lessons expired. The Tax Court, applying the claim of right doctrine, held that all cash and all notes must be reported as taxable income fully in the year of receipt. The Court of Appeals for the Eighth Circuit reversed, agreeing whole-heartedly with the opinion of the Second Circuit in *Bressner Radio, Inc., supra.* Said the Eighth Circuit:

> "Even indulging the assumption that petitioners came into possession of the monetary amount of the contracts when executed within the contemplation of the claim of right doctrine, we are satisfied that to apply the doctrine to petitioners' operation, without regard to its accrual system of accounting, would result in emasculation of the law long recognized, which affords taxpayers the right 'to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period.' *United States* v. *Anderson, supra*, 269 U.S. at page 440, 46 S. Ct. at page 134."[34]

[34] 283 F. 2d at 241.

5. The decision of this Court in Automobile Club of Michigan v. Commissioner, supra, should not be controlling here because petitioner has proved its method of accounting reflects its income clearly

The accounting question was only one of three different issues argued before and decided by this Court in *Automobile Club of Michigan, supra.* The opinion of this Court on the accounting issue indicates that its decision was grounded primarily upon the facts—or lack of facts—produced in evidence in that case. In its majority opinion, this Court stated:

> "The pro rata allocation of the membership dues in monthly amounts is purely artificial and *bears no relation to the services which petitioner may in fact be called upon to render for the member.* . . . We cannot say, *in the circumstances here*, that the discretionary action of the Commissioner, sustained by both the Tax Court and the Court of Appeals, exceeded permissible limits."[35] (Italics supplied.)

In the *Automobile Club of Michigan* case, no evidence was produced to support the fact that the method of accounting employed by the Michigan Club was in accord with generally accepted accounting principles or clearly reflected its income. No accountants were placed on the stand. Little or no evidence was introduced with respect to the cost of serving the members of the Club or with respect to the correlation, if any, between the cost incurred in serving a member and the period of time over which advance dues were recognized as income. The Tax Court did not find as a fact that the method of accounting employed by the Michi-

[35] 353 U.S. at 189.

gan Club was in accord with accepted accounting principles, as the Court of Claims did in the case at bar.

Without evidence on these points this Court had little choice except to conclude that "in the circumstances here" the Commissioner of Internal Revenue should be upheld.[56]

The conclusion that the decision of this Court in *Automobile Club of Michigan* was grounded upon the facts or lack of facts in that case is fortified by this Court's reference to *Beacon Publishing Company* v. *Commissioner, supra*, and *Schuessler* v. *Commissioner*,[57] both of which were distinguished on their facts. Footnote 20 of the majority opinion reads as follows:

> "Beacon Publishing Co. v. Commissioner (CA 10th) 218 F. 2d 697, and Schuessler v. Commissioner (CA 5th) 230 F. 2d 722, are distinguishable on their facts. In Beacon, performance of the subscription, in most instances, was, in part, necessarily deferred until the publication dates after the tax year. In Schuessler, performance of the service agreement required the taxpayer to furnish services at specified times in years subsequent to the tax year. In this case, substantially all services are performed only upon a member's demand and the taxpayer's performance was not related to fixed dates after the tax year. We express no opinion upon the correctness of the decisions in Beacon or Schuessler."[58]

In the case at bar petitioner was able to establish that the recognition of dues as income over the life

[56] 353 U.S. at 753.

[57] 230 F. 2d 722 (5th Cir. 1956).

[58] 353 U.S. at 189, n. 20.

of the membership, was not artificial but was practical and realistic, because a direct relationship existed between the costs incurred in serving its members and the period of time over which advance dues were recognized as income.

Most law review writers who have analyzed the decision of this Court in *Automobile Club of Michigan* concluded that this Court would approve a realistic deferral of prepaid income if the taxpayer's income was reflected clearly.[59]

6. The method of accounting employed by petitioner does reflect its income clearly

As the principles of accrual accounting discussed in this brief are applied to prepaid dues received by the petitioner from its members, it becomes clear that such dues upon collection constitute a liability, not income. The liability diminishes and income arises as the obligation of petitioner to its members is satisfied by performance or as the obligation expires. At the end

[59] Behren, "Prepaid Income Accounting Concepts and the Tax Law," 15 Tax L. Rev. 343, 359, 360 (1960) states:

> "The Supreme Court implied that a realistic deferral would have been permissible and found only that no realistic deferral had been made. Thus the issue of the inclusion of prepaid income, *properly allocated* to future periods, in current taxable income was not passed upon by the Supreme Court."

In Note, "Taxation of Prepaid Income: a Temporary Solution," 67 Yale L. J. 1425, 1440 (1958) it is stated with respect to the *Michigan Club* case:

> ". . . Thus, an automobile club could defend its method of allocating any individual's dues by demonstrating the average services requested by a member for a particular period."

See Note, 59 Col. L. Rev. 942, 944 (1959); Note, 1960 Duke L. J. 127, 131-134.

of each annual accounting period the portion of advance dues for which services have not yet been rendered and for which costs have not yet been incurred must continue to be reflected as a liability until the next year when performance takes place or the obligation expires. Only by this procedure will true income be clearly reflected.

A member of a motor club buys in essence the availability of motor and traveling service—and protection against common motoring mishaps. The liability of the club to the member is satisfied as time expires whether or not the member uses the club. As the obligation of the club to serve its members expires, advance dues received from members must be reflected by the club as income or revenue. There may be members of a motor club who hope they will never have to use some of its services, particularly emergency road service. This does not mean, however, that the club does not incur expenses in behalf of such members for the club at all times must incur the costs necessary to maintain the availability of services. To make its services available the club must pay the salaries of its officers and employees, pay the operating expenses of its headquarters and incur numerous other expenses simply because its members have the right to use the club.

Petitioner is able to predict with a high degree of accuracy the costs which it will incur in serving its members on a monthly or annual basis.

At the trial of this case petitioner's testimony consisted of that of its staff auditors, supplemented by outstanding certified public accountants testifying as experts who were familiar with petitioner's problem

or had some direct association with it and whose qualifications were not challenged.

Based upon such testimony and the documentary evidence produced by petitioner, the Commissioner of the Court of Claims before whom the case was tried made the following findings of fact, among others:

> "The advance payment on a service contract, or any other type of contract, does not constitute income or revenue to the recipient, although the acceptance thereof creates a liability to perform. Under generally accepted accounting principles, the accounting for the funds received in advance must be recorded as a liability of the recipient. The plaintiff did this consistently since 1931. These membership contracts entitled the members to receive membership services over a period of 12 months from the date of subscription and acceptance. . . .
>
> "The method of accounting employed by plaintiff was in accordance with accepted accounting principles. The assignment and transfer of funds from the prepaid dues account to revenue or gross income measured over the period of the membership contracts is found to be the most realistic method for properly recording gross income from dues."[60]
>
> "On the evidence presented, the recognition and assignment of prepaid dues ratably over the period of membership is found to be the most realistic and practical method of accounting for gross income from membership dues."[61]
>
> "The plaintiff's liability for servicing members whose membership continued beyond the current

[60] Finding 25, R. 21, 22.

[61] Finding 29, R. 24.

year when dues were paid was not a 'contingent' liability. It was a true liability and the costs were substantially in proportion to membership from year to year with reasonable constancy from month to month. . . ."[62]

"The plaintiff's liability to members for that portion of their memberships which extended beyond the current year in which plaintiff collected the dues in advance is not gross income from membership dues because it was paid and received for a later year. Neither can it be net income in the year when the dues were received because the cost of servicing such memberships could not be performed until the following year when such net income would be realized.

"The method of accounting employed by the plaintiff during the calendar years 1953 and 1954 and prior years in keeping its books and records clearly reflected its net income for such years. The plaintiff's income tax returns for 1953 and 1954 were prepared in accordance with the method of accounting employed in keeping its books and records and clearly reflected the net income for these years. This conclusion and the findings set forth above are supported by the overwhelming weight of the documentary evidence and expert testimony."[63]

And with respect to the so called method of accounting which the Commissioner of Internal Revenue seeks to force upon petitioner, the Commissioner of the Court of Claims made the following findings of fact:

(1) ". . . This application of the receipt of funds as income is contrary to generally accepted accounting principles and practices."[64]

[62] Finding 31, R. 24, 25

[63] Finding 33, R. 26.

[64] Finding 24, R. 20.

(2) "... the adjustments by the Commissioner of the Internal Revenue Service, reflects an overstatement of surplus for 1953 of $1,358,003.10, or approximately 54% in excess of the true surplus."[65]

(3) "By applying similar adjustments to plaintiff's balance sheet as of December 31, 1954, the surplus would be increased and overstated by $1,634,840.81, or approximately 99 percent, and would omit plaintiff's liability to members for a similar amount."[65]

(4) "The evidence establishes that reputable members of the accounting profession would not certify to the accuracy of the income statements and the balance sheets reflecting the adjustments by the Commissioner of the Internal Revenue Service."[65]

Some of these findings were not included by the Court of Claims in its findings of fact, but the Court itself did find the following facts:

"The plaintiff's costs for servicing members were substantially in proportion to membership from year to year with reasonable constancy from month to month. . . ."[66]

"The method of accounting employed by plaintiff during the years in issue has been used regularly by plaintiff since 1931 and is in accord with generally accepted commercial accounting principles and practices. . . ."[67]

"Had the plaintiff recognized, assigned and transferred to its gross income account its monthly receipts of dues collected in advance in the proportion to its cost of servicing all of its members each month, instead of ratably over the member-

[65] Finding 24, R. 21.

[66] Finding 30, R. 70.

[67] Finding 22, R. 66.

> ship period of 12 months, the proportion of advance dues which would have been recognized and assigned to gross income during the years in issue herein would have been substantially the same as the gross income from dues as determined and reported by the plaintiff under the method of accounting actually employed."[68]

Since the petitioner in the case at bar established by clear and uncontradicted evidence that its method of accounting was not artificial and did clearly reflect its income, these findings should dispose of the case in petitioner's favor.

The decision below is inconsistent with the primary findings of fact made by the Court of Claims, which situation calls for an exercise of this Court's power of supervision as in *United States* v. *Penn Foundry & Mfg. Co.*[69]

In view of the facts established in this case, petitioner respectfully urges this Court not to lay down a broad, sweeping rule of law that under no circumstances may funds collected in advance of performance by an accrual basis taxpayer be reported as taxable income later than the year of receipt. Nor does petitioner request this Court to hold that prepaid receipts may always be deferred—unless necessary to match appropriate costs with related revenue and to reflect income clearly. Petitioner merely requests that the decision of this Court be rendered in the light of existing statutes as applied to the facts proved in this case.[70]

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[68] Finding 26, R. 68.

[69] 337 U.S. 198 (1949).

[70] See *Commissioner* v. *Duberstein*, —— U.S. ——, 4 L. Ed. 2d 1218 (1960); *Stanton* v. *United States*, —— U.S. ——, 4 L. Ed. 2d 1218 (1960); *United States* v. *Kaiser*, —— U.S. ——, 4 L. Ed. 2d 1233 (1960).

CONCLUSION AND RELIEF REQUESTED

Petitioner respectfully requests this Court to hold that in the circumstances here petitioner has proved its method of accounting clearly reflects its income and accordingly is acceptable for tax purposes. Petitioner therefore prays that the judgment entered by the court below should be reversed.

Respectfully submitted.

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APPENDIX

Internal Revenue Code 1939:

"SEC. 41. GENERAL RULE.

"The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *"

"SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

"* * * The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *"

Regulations 118:

"§ 39.41-1 *Computation of net income.* Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditure which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a

manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See §§ 39.42-1 to 39.42-3, inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

"§ 39.41-2 *Bases of computation and changes in accounting methods.* (a) Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 48 for definitions of 'paid or accrued' and 'paid or incurred.' All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. * * *

* * * *

"§ 39.42-1 *When included in gross income.*—(a) *In general.* Except as otherwise provided in section 42, gains, profits, and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included as of a different period in accordance with the approved method of accounting followed by him. See §§ 39.41-1 to 39.41-3, inclusive. * * *"

Internal Revenue Code of 1954:

"SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

"(a) *General Rule.*—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

"(b) *Exceptions.*—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

"(c) *Permissible Methods.*—Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—

(1) the cash receipts and disbursements method;

(2) an accrual method;

(3) any other method permitted by this chapter; or

(4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary or his delegate.

"(d) *Taxpayer Engaged in More Than One Business.*—A taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade or business.

"(e) *Requirement Respecting Change of Accounting Method.*—Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary or his delegate.

"SEC. 451. GENERAL RULE FOR TAXABLE YEAR OF INCLUSION.

"(a) *General Rule.*—The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

"(b) *Special Rule in Case of Death.*—In the case of the death of a taxpayer whose taxable income is computed under an accrual method of accounting, any amount accrued only by reason of the death of the taxpayer shall not be included in computing taxable income for the period in which falls the date of the taxpayer's death."

Regulations Promulgated Under the 1954 Code:

"§ 1.446-1 (T.D. 6282, filed 12-24-57.)

"*General rule for methods of accounting*—(a) *General rule.* (1) Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. The term 'method of accounting' includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item. Examples of such over-all methods are the cash receipts and disbursements method, an accrual method, combinations of such methods, and combinations of the foregoing with various methods provided for the accounting treatment of special items. These methods of accounting for special items include the accounting treatment prescribed for research and experimental expenditures, soil and water conservation expenditures, depreciation, net operating losses, etc. Except for deviations permitted or required by such special accounting treatment, taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. For requirement respecting the adoption or

change of accounting methods, see section 446(e) and paragraph (e) of this section.

"(2) It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

"(3) Items of gross income and expenditures which are elements in the computation of taxable income need not be in the form of cash. It is sufficient that such items can be valued in terms of money. For general rules relating to the taxable year for inclusion of income and for taking deductions, see sections 451 and 461 and the regulations thereunder.

* * * *

"§ 1.451-1 (T.D. 6282, filed 12-24-57.)

"*General rule for taxable year of inclusion*—(a) *General rule.*—Gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting. Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Therefore, under such a method of accounting if, in the case of compensation for services, no determination can be made as to the right to such compen-

sation or the amount thereof until the services are completed, the amount of compensation is ordinarily income for the taxable year in which the determination can be made. Under the cash receipts and disbursements method of accounting, such an amount is includible in gross income when actually or constructively received. Where an amount of income is properly accrued on the basis of a reasonable estimate and the exact amount is subsequently determined, the difference, if any, shall be taken into account for the taxable year in which such determination is made. To the extent that income is attributable to the recovery of bad debts for accounts charged off in prior years, it is includible in the year of recovery in accordance with the taxpayer's method of accounting, regardless of the date when the amounts were charged off. For treatment of bad debts and bad debt recoveries, see sections 166 and 111 and the regulations thereunder. For rules relating to the treatment of amounts received in crop shares, see section 61 and the regulations thereunder. For the year in which a partner must include his distributive share of partnership income, see section 706(a) and § 1.706-1(a). If a taxpayer ascertains that an item should have been included in gross income in a prior taxable year, he should, if within the period of limitation, file an amended return and pay any additional tax due. Similarly, if a taxpayer ascertains that an item was improperly included in gross income in a prior taxable year, he should, if within the period of limitation, file claim for credit or refund of any overpayment of tax arising therefrom."